

**METALS & MINING**

28 April 2021

**Expert call with China's Valin Steel on 'new normal' for industry**

We hosted a call with the management of Valin Steel (Valin), amongst the top 5 steel producers in China. Valin believes that the 'new normal' for China's steel industry will be based on a cap on domestic steel supply, adequate demand support and decreasing costs. In the near term, the Chinese government is likely to focus on production cuts in crude steel and improving its availability for domestic use. This should help ease iron ore cost inflation and, in turn, steel prices in H2CY21.

Kirtan Mehta, CFA  
research@bobcaps.in

**Carbon neutrality to drive long-term cap on supply:** China's plans to achieve peak carbon emissions and carbon neutrality could put a cap on the country's domestic supply in the long term. With the steel industry looking to achieve peak carbon emissions by CY25 as per the draft plan submitted by industry association CISA, there is a possibility of a medium-term supply squeeze as well. This is because the industry will need to curtail emissions ahead of the availability of new clean technologies. Players are likely to increase usage of scrap and enhance EAF production capacity.

**Potential 20mt production cut in CY21:** Valin believes that the Chinese government is considering a 20mt cut in annual crude steel production in CY21. This could translate into a significant 60-70mt reduction over May-Dec'21 as YTD production is running 30-40mt above last year's level. The cuts will likely be targeted at steelmakers with a poor environmental performance, high energy consumption and/or relatively backward technology and equipment.

**Adequate demand support:** While China's steel production could peak in the medium term, its steel consumption will continue to rise. The country's steel demand is likely to be supported by domestic import replacement and an increase in exports for infrastructure development overseas under the Belt and Road initiative.

**Decrease in raw material costs:** Besides a potential production cut in CY21, the government is likely to adjust import and export tariffs in the steel value chain to improve availability of steel for domestic use and to control raw material inflation. By lowering production, China's import demand for iron ore will reduce, in turn cooling down prices of both iron ore and steel in H2CY21. The likely increase in global supply of iron ore in CY21 will also help ease price pressures.



## ‘New normal’ for China’s steel industry

We hosted Valin Steel of China, an integrated solution provider of steel products and amongst the top 5 steel producers in China. The company earned operating revenue of US\$ 12.8bn and net profit of US\$ 0.7bn in 9MCY20 – equivalent to ~40% of revenue and 60% of net profit of the top player in China’s steel industry. The company was represented by Liu Xiaofei, Director – Securities Department; Wang Yin, Manager – IR; and Zhou Yujian, Manager – IR.

Valin believes that the ‘new normal’ for China’s steel industry will be based on capacity limits on domestic supply, adequate demand support and decreasing costs. We discuss the key call takeaways below.

### Cap on domestic steel supply

- **Long-term cap on supply:** China’s plans to achieve peak carbon emissions and carbon neutrality have the potential to cap domestic supply in the country over the long term, halting the capacity expansion cycle of the past two decades. The industry will have to adopt new technologies to contain carbon emissions.
- **Medium-term supply squeeze:** The Chinese steel industry is aiming to achieve peak carbon emissions by 2025, as per the draft plan submitted by CISA for government approval. This has the potential to squeeze domestic supply as the industry will have to meet emission norms even before the availability of new clean technologies. Attempts will be made to increase usage of scrap and enhance EAF production capacity to lower carbon emissions.
- **Potential 20mt production cut in CY21:** Valin believes the government is targeting a 20mt cut in annual crude steel production in CY21. With Jan-Apr’21 production running 30-40mt above last-year levels, this could effectively translate into a 60-70mt reduction (6-7% of annual production) for the rest of the year. The government is likely to focus on steelmakers with poor environmental performance, high energy consumption and relatively backward technology and equipment.

Some of the specific steps highlighted were –

- Government officials have started investigations to identify any illegal capacity put in place during implementation of old capacity replacement.
- The government has initiated environmental inspections in eight provinces in April to identify steel capacity with poor environmental performance.
- The Ministry of Industry and Information Technology (MIIT) has solicited public comments to plug loopholes in applying prescribed limits when replacing old capacity.

- MIIT and National Development Reform Commission (NDRC) are likely to work out an action plan for production cuts and communicate this to provinces for implementation.

### Adequate demand support

While China's steel production could peak in the medium term, its steel consumption will continue to rise. The country's steel demand is likely to be supported by domestic import replacement and increasing exports for infrastructure development overseas under the Belt and Road initiative.

- While demand from the country's real estate sector is likely to peak in the medium term, the impact is expected to be balanced by steel demand from the infrastructure segment. China still has infrastructure development needs in its tier-3 and tier-4 cities.
- Demand in real estate is benefitting from "shantytown renovation" upgrades and urban renewal. Steel demand from housing has increased from 50kg per square meter to 60kg.
- Consumption in the infrastructure sector is related to upgrading concrete and steel construction with steel plates. Bridges are now being upgraded from reinforced concrete construction to steel box girder structures.
- Steel demand may get further impetus from infrastructure development overseas targeted under the Belt and Road initiative.

### Decreasing costs for steel industry

The increase in cost of production over the past 6-9 months has had a mixed impact on China's steel industry. While high-end steel producers have been able to pass on higher costs to consumers and protect their margins, rebar producers have faced a relatively deeper negative impact.

To control the impact of raw material inflation, the government is likely to adjust import and export tariffs in the steel value chain to increase availability of steel for domestic consumption. By lowering production, China's import demand for iron ore will reduce, in turn cooling down prices of both iron ore and steel in H2CY21. The likely increase in global supply of iron ore in CY21 will also help ease price pressures.

In the medium term, the government is encouraging the industry to participate in development of iron ore mines overseas. Domestically as well, the tax burden may be lowered to help increase production.

## Disclaimer

### Recommendation scale: Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

**ADD** – Expected return from >+5% to +15%

**REDUCE** – Expected return from -5% to +5%

**SELL** – Expected return <-5%

**Note:** Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

### Rating distribution

As of 31 March 2021, out of 88 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 42 have BUY ratings, 13 have ADD ratings, 5 are rated REDUCE and 28 are rated SELL. None of these companies have been investment banking clients in the last 12 months.

### Analyst certification

The research analyst(s) authoring this report hereby certifies that (1) all of the views expressed in this research report accurately reflect his/her personal views about the subject company or companies and its or their securities, and (2) no part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of BOBCAPS.

### General disclaimers

BOBCAPS is engaged in the business of Institutional Stock Broking and Investment Banking. BOBCAPS is a member of the National Stock Exchange of India Limited and BSE Limited and is also a SEBI-registered Category I Merchant Banker. BOBCAPS is a wholly owned subsidiary of Bank of Baroda which has its various subsidiaries engaged in the businesses of stock broking, lending, asset management, life insurance, health insurance and wealth management, among others.

BOBCAPS's activities have neither been suspended nor has it defaulted with any stock exchange authority with whom it has been registered in the last five years. BOBCAPS has not been debarred from doing business by any stock exchange or SEBI or any other authority. No disciplinary action has been taken by any regulatory authority against BOBCAPS affecting its equity research analysis activities.

BOBCAPS has obtained registration as a Research Entity under SEBI (Research Analysts) Regulations, 2014, having registration No.: INH000000040 valid till 03 February 2025. BOBCAPS is also a SEBI-registered intermediary for the broking business having SEBI Single Registration Certificate No.: INZ000159332 dated 20 November 2017.

BOBCAPS prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, BOBCAPS prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of BOBCAPS's clients. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. BOBCAPS does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment in certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities — that give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavour to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so.

We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have “long” or “short” positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein and may from time to time add to or dispose of any such securities (or investment). We and our affiliates may act as market makers or assume an underwriting commitment in the securities of companies discussed

in this document (or in related investments), may sell them to or buy them from customers on a principal basis, and may also perform or seek to perform investment banking or advisory services for or relating to these companies and may also be represented in the supervisory board or any other committee of these companies.

For the purpose of calculating whether BOBCAPS and its affiliates hold, beneficially own, or control, including the right to vote for directors, one per cent or more of the equity shares of the subject company, the holdings of the issuer of the research report is also included.

BOBCAPS and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the Risk disclosure document before entering into any derivative transactions.

In the US, this material is only for Qualified Institutional Buyers as defined under rule 144(a) of the Securities Act, 1933. No part of this document may be distributed in Canada or used by private customers in the United Kingdom.

No part of this material may be (1) copied, photocopied, or duplicated in any form by any means or (2) redistributed without BOBCAPS's prior written consent.

### **Company-specific disclosures under SEBI (Research Analysts) Regulations, 2014**

The research analyst(s) or his/her relatives do not have any material conflict of interest at the time of publication of this research report.

BOBCAPS or its research analyst(s) or his/her relatives do not have any financial interest in the subject company. BOBCAPS or its research analyst(s) or his/her relatives do not have actual/beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

The research analyst(s) has not received any compensation from the subject company in the past 12 months. Compensation of the research analyst(s) is not based on any specific merchant banking, investment banking or brokerage service transactions.

BOBCAPS or its research analyst(s) is not engaged in any market making activities for the subject company.

The research analyst(s) has not served as an officer, director or employee of the subject company.

BOBCAPS or its associates may have material conflict of interest at the time of publication of this research report.

BOBCAPS's associates may have financial interest in the subject company. BOBCAPS's associates may hold actual / beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

BOBCAPS or its associates may have managed or co-managed a public offering of securities for the subject company or may have been mandated by the subject company for any other assignment in the past 12 months.

BOBCAPS may have received compensation from the subject company in the past 12 months. BOBCAPS may from time to time solicit or perform investment banking services for the subject company. BOBCAPS or its associates may have received compensation from the subject company in the past 12 months for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory services in a merger or specific transaction. BOBCAPS or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.